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No. 06-1413

Supreme Court, U.S.
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In The
Supreme Court of the United States

MEADWESTVACO CORPORATION, SUCCESSOR IN INTEREST TO THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Writ Of Certiorari To The Appellate Court Of Illinois

BRIEF OF PETITIONER

BETH S. BRINKMANN
BRIAN R. MATSUI
NICOLE D. DEVERO
MORRISON & FOERSTER LLP
2000 Pennsylvania Ave., N.W.
Washington, DC 20006
(202) 887-1544

PAUL H. FRANKEL
Counsel of Record
CRAIG B. FIELDS
ROBERTA MOSELEY NERO
MORRISON & FOERSTER LLP
1290 Avenue of the Americas
New York, NY 10104
(212) 468-8000

Counsel for Petitioner

NOVEMBER 5, 2007

COCKLE LAW BRIEF PRINTING CO. (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTION PRESENTED

Is the attempt by Illinois to tax the approximately $1 billion gain realized by petitioner when it sold its investment in Lexis/Nexis in 1994 (which it acquired in 1968 for $6 million and which functioned for 26 years as an independent, nonunitary business) in direct conflict with the Due Process and Commerce Clauses of the United States Constitution and the decisions of the Court?

PARTIES TO THE PROCEEDING

The parties to the proceeding are listed in the caption.

RULE 29.6 CORPORATE DISCLOSURE STATEMENT

Petitioner MeadWestvaco Corporation is the successor in interest to The Mead Corporation, which was a publicly held company with no parent company or publicly held company owning more than 10 percent of the company's stock during the year ended December 31, 1994, which is the tax period involved in the dispute.

Petitioner MeadWestvaco Corporation was formed as of January 29, 2002. From January 29, 2002 through December 31, 2002, MeadWestvaco Corporation functioned as a holding company with two assets—all of the stock of The Mead Corporation and all of the stock of Westvaco Corporation. On December 19, 2002, MW Custom Papers, Inc. was incorporated. On December 31, 2002, The Mead Corporation was merged into MW Custom Papers, Inc. Later on December 31, 2002, MW Custom Papers, Inc. was converted into MW Custom Papers, LLC. After this conversion, the majority of the operations and assets previously owned by The Mead Corporation and then contained within MW Custom Papers, LLC were transferred to MeadWestvaco Corporation. MeadWestvaco Corporation is a publicly held company with no parent company or publicly held company owning more than 10 percent of MeadWestvaco Corporation's stock.

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OPINIONS BELOW

The denial by the Supreme Court of Illinois of the petition for leave to appeal (Pet. App. 41a) is reported at 222 Ill. 2d 609, 862 N.E.2d 235.

The opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division (Pet. App. 1a-22a) is reported at 371 Ill. App. 3d 108, 861 N.E.2d 1131. The order of the Appellate Court of Illinois, First Judicial District, granting the respondents' motion to publish the ruling as a precedential decision is unreported. Pet. App. 23a-24a.

The Memorandum Decision, Judgment and Order of the Circuit Court of Cook County, Illinois is unreported. Pet. App. 28a-40a. The Final Judgment Order of the Circuit Court of Cook County is unreported. Pet. App. 25a-27a.

JURISDICTION

The opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division, was entered on January 12, 2007. The Supreme Court of Illinois denied the petition for leave to appeal on January 24, 2007. Petitioner timely filed its petition for a writ of *certiorari* on April 20, 2007. This Court granted the petition on September 25, 2007. This Court's jurisdiction is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution provides in relevant part: "The Congress shall have Power * * * [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. Const. art. I, § 8, cl. 3 (the Commerce Clause).

The Fourteenth Amendment to the United States Constitution provides in relevant part: "No State shall * * * deprive any person of life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1 (the Due Process Clause).

INTRODUCTION

The State of Illinois taxed The Mead Corporation, a paper and office supplies business, for the gain that it derived from the sale of Lexis/Nexis, the computerized information retrieval business, despite the fact that Mead is not domiciled in Illinois and Lexis/Nexis served no operational function to Mead.

Illinois's imposition of that tax in such circumstances violated the Due Process and Commerce Clauses of the United States Constitution because Illinois did not have an adequate connection to the sale of the asset to tax that gain. Although Illinois may tax the income that Mead derived from its paper and office supplies business that operated in

Illinois and other States through an apportionment among the various States in which that business operated, Illinois cannot impose a tax on Mead's gain from the sale of an asset that did not have an adequate connection to the operation of that multi-state business.

The decision below discards these well-settled constitutional principles, and creates what would amount to a bright-line rule that States can tax an apportioned share of the gain earned on the sale of a multi-state corporation's business units irrespective of whether that business unit has any minimal connection with the corporation's business that is conducted within the taxing State. This Court has repeatedly rejected such attempts by States to elevate corporate form over constitutional substance. The Constitution looks not to whether the business unit has a connection to the taxpayer, but requires instead that the business unit be connected to the taxpayer's business in the State, through functional integration, centralization of management, economies of scale or by otherwise providing critical operational support to the taxpayer's in-State business, such as through working capital or by ensuring access to key resources.

STATEMENT

A. Statutory And Factual Background

1. The Illinois Tax

The State of Illinois determines how much of the income of a corporation that operates in multiple States it can tax by looking to the form of the income of the corporation. Section 1501 of the Illinois Compiled Statutes distinguishes between two forms of income for this purpose, and each is subject to different methods of taxation: "business income" and "nonbusiness income."

During the relevant period, "business income" under Illinois law was defined as income that arises "from transactions and activity in the regular course of the taxpayer's trade or business." 35 Ill. Comp. Stat. Ann. 5/1501(a)(1) (West 1994). Business income "include[d] income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." *Ibid.* Such business income of a multi-state business was taxed by Illinois according to the portion of that business that can be apportioned to Illinois as opposed to the other States in which the business operates. That portion is determined through a state law formula that calculates "Illinois property in proportion to all property" of the multi-state business; "Illinois payroll in proportion to all payroll" of the multi-state business; and "Illinois sales in proportion to all sales" of the multi-state business. Pet. App. 8a;

see also 35 Ill. Comp. Stat. Ann. 5/304(a) (West 1994). In tax terminology, such business income is "apportionable" according to the formula among all the States in which the multi-state business is subject to taxation, and each State can tax its apportioned share.

By contrast, "nonbusiness income" is defined by Illinois to "mean[ ] all income other than business income or compensation." 35 Ill. Comp. Stat. Ann. 5/1501(a)(13) (West 1994). Illinois does not subject that income to apportionment; rather, if such income is taxable in Illinois, the State taxes that income in its entirety as if it is subject to taxation only in Illinois. In tax parlance, this nonbusiness income is "allocated" to that one State.[1]

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[1] The Illinois statutory provisions are derived from the Uniform Division of Income for Tax Purposes Act (UDITPA). Illinois, like most of its sister States, has enacted a modified version of UDITPA. Each jurisdiction has placed its own construction on UDITPA, either by legislative amendment, regulation, or judicial construction. *See* Jerome Hellerstein, Walter Hellerstein & Joan Youngman, *State and Local Taxation* 605-606 (8th ed. 2005). Accordingly, the rule articulated in one jurisdiction does not necessarily apply to all the other States that have enacted UDITPA in some form. *Id.* And this Court has long recognized that state taxation under UDITPA and state taxation that is *constitutionally* permissible are not coextensive. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 786-787 (1992) (declining to adopt UDITPA as the constitutional test). Indeed, in recognition that its tax scheme and the Constitution were not coextensive, in 2003 Illinois amended its definition of business income, and now defines it as "all income that may be treated as apportionable business income under the

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Under this scheme, if a multi-state corporation that is not domiciled in Illinois derives income from the sale of an asset which is an *integral* part of a regular trade or business that it operates, that income can be apportioned amongst the several States in which that business is conducted and which may tax its portion of the business. If, however, that multi-state corporation derives a gain from the sale of an asset that is an investment that is *not* part of its regular trade or business, then that gain is nonbusiness income that is not apportioned among other States for taxation but is taxed only by the corporation's commercial domicile (or site of the investment if it is real property).

2. The Mead Corporation's Investment In Lexis/Nexis

The issue before this Court involves Illinois's taxation of The Mead Corporation (predecessor to petitioner MeadWestvaco Corporation), a multi-state corporation, for a portion of the gain that it derived from its sale of Lexis/Nexis in 1994.

The Mead Corporation was incorporated under the laws of Ohio. It was headquartered in Dayton, Ohio and maintained its commercial domicile there. J.A. 5. The Mead Corporation was (and its successor MeadWestvaco is) engaged in the production and

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Constitution of the United States." 35 Ill. Comp. Stat. Ann. 5/1501(a)(1) (West 2003).

sale of forest products, including paper, packaging and paperboard, and office and school supplies. J.A. 9.

a. Acquisition and growth of Lexis/Nexis. The Mead Corporation acquired Data Corporation in 1968 for $6 million. *Ibid.* Mead was interested primarily in Data Corporation for its ink-jet printing technology, which related to Mead's paper and office supplies business. Data Corporation also happened to possess reconnaissance technology and a full-text information retrieval technology, which later was developed into Lexis/Nexis. J.A. 152-153 (Testimony of James P. Roemer ("Roemer Testimony")).

Shortly after The Mead Corporation acquired Data Corporation, the information retrieval technology part of Data Corporation was transferred to an entity separate from The Mead Corporation, which was designated Mead Data Central. J.A. 9. Between 1968 and 1972, Mead Data Central worked with bar associations in Ohio and Missouri to develop its full-text information retrieval technology into a service that would assist in researching the law. The Mead Corporation provided some investment capital to sustain these efforts, J.A. 169 (Roemer Testimony), but The Mead Corporation, itself, continued to focus on its paper and office supplies business.

By 1973, Mead Data Central became known as Lexis and was launched as a legal information retrieval technology service on a nationwide basis. J.A. 153 (Roemer Testimony). In 1975, Lexis reached

a critical turning point because most courts, and then most law firms, had become its customers. J.A. 154 (Roemer Testimony). Nexis, a news and information service aimed at the financial market, was launched a few years later, and the service then became known as Lexis/Nexis. J.A. 9. Within a decade, Lexis/Nexis had grown from a small legal database into the world's premier provider of online legal research information and the pioneer of computer-assisted news retrieval. *Ibid.*

b. The separate operations of The Mead Corporation's paper and office supplies business and the Lexis/Nexis online research business. The Mead Corporation engaged in no daily oversight of Lexis/Nexis. Instead, Lexis/Nexis's separate online information retrieval business developed its own computer technology culture, practices, and business plans, which ultimately helped foster that investment's substantial growth and success. J.A. 162, 166-167 (Roemer Testimony), 174 (Testimony of James M. McGrane ("McGrane Testimony")). The involvement of The Mead Corporation's board of directors with Lexis/Nexis was limited to consultation about the hiring of only its most senior corporate executives, major capital expenditures, changes to Lexis/Nexis's legal structure and other large, nonrecurring transactions. J.A. 13, 15.[2]

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[2] Lexis/Nexis merged into and became a division of Mead in 1980. In 1985, Lexis/Nexis was reincorporated as a separate

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Lexis/Nexis and The Mead Corporation maintained separate brand names and separate bank accounts. J.A. 10.[3] There were no transfers of sales or accounts receivables between the two companies. J.A. 11.[4]

Mead had separate headquarters from Lexis/Nexis, as well as separate manufacturing, sales, and distribution facilities. J.A. 12-13. Lexis/Nexis maintained its own full-time management to control its day-to-day operations and maintained its own departments, including: accounting, internal auditing, credit and collections, human resources,

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subsidiary of Mead. J.A. 164 (Roemer Testimony). In 1993, Lexis/Nexis again merged into and became a division of Mead. Tax savings were considered in both of the mergers. J.A. 14. The change in the legal relationship between Mead and Lexis/Nexis did not in any manner affect the operations of Lexis/Nexis. J.A. 165 (Roemer Testimony), J.A. 176-177 (Testimony of Timothy R. McLevish ("McLevish Testimony")).

[3] Although the Mead name appeared in some Lexis/Nexis advertising, it was never prominent; "LEXIS/NEXIS" was the brand name of the computerized information retrieval service and was the name by which the company was known to its customers. J.A. 171 (McGrane Testimony). Indeed, although Lexis/Nexis employees had Mead business cards that they used when they were with Mead executives, they also had Lexis/Nexis cards which they used the majority of the time because it was the Lexis/Nexis name that was recognized in the industry. J.A. 162-163 (Roemer Testimony).

[4] On occasion, Mead invested Lexis/Nexis's own excess funds, but those funds, and the investment returns on those funds, accrued specifically to Lexis/Nexis. J.A. 180-182 (McLevish Testimony).

real estate management, purchasing, and marketing. Even the functions that could have been shared by these divergent businesses—such as security, in-house and outside legal counsel, and employee benefits packages—were kept distinct from one another. J.A. 10-13. Mead's customers received no discount if they were also Lexis/Nexis customers, and Lexis/Nexis' customers likewise did not receive any discount if they were also Mead customers. J.A. 163-164 (Roemer Testimony).

Indeed, even Mead, itself, was billed as a regular customer by Lexis/Nexis, and paid as such, for the Lexis/Nexis services it used. J.A. 164 (Roemer Testimony). And Mead, in turn, did not offer any discount to Lexis/Nexis for the paper that Lexis/Nexis used. In fact, Lexis/Nexis primarily purchased its paper from *other* sources. J.A. 168 (Roemer Testimony).

*c. **Mead's sale of Lexis/Nexis.*** On May 16, 1994, The Mead Corporation announced its intent to sell Lexis/Nexis, J.A. 14, and completed that sale for approximately $1.5 billion on December 2, 1994. *Ibid.* The Mead Corporation and its successor have had no further investment or interest in any electronic publishing or online information retrieval business. *Ibid.*

Mead used the gain on its sale of Lexis/Nexis for a stock repurchase program ($349,664,065), to retire debt ($725,550,000), to pay taxes ($424,700,000), and for other purposes ($85,935). J.A. 14-15. Mead

repurchased the shares of stock and paid off outstanding debt in order to maximize the value of its stock for its shareholders and to minimize its vulnerability to a corporate takeover. J.A. 15.

B. Proceedings Below

1. After The Mead Corporation sold Lexis/Nexis, the State of Illinois issued two notices of tax deficiency to Mead asserting, among other issues not relevant to the case now before this Court, that The Mead Corporation was required to apportion its gain from its sale of Lexis/Nexis to Illinois so that Illinois could tax The Mead Corporation for a share of Mead's gain on the sale.

Mead paid that Illinois tax under protest, Pet. App. 5a, and then brought the instant suit for a refund in the Circuit Court of Cook County, asserting that Illinois lacked a sufficient constitutional nexus to Mead's investment in Lexis/Nexis to tax any part of Mead's gain from its sale of Lexis/Nexis.

The Cook County court ruled that Mead is a distinct business from the Lexis/Nexis computerized online information retrieval service business, and thus the two businesses are *not* one unitary business for tax purposes. *Id.* at 35a-39a. The court held that the two businesses "were not functionally integrated, there was no centralization of management and no significant economies of scale between the two businesses." *Id.* at 39a. Rather, the court found that the two businesses maintained separate departments,

resources, and procedures, and that the only manner in which there was *any* integration was the "extraordinary purchases requiring capital investment and the interest rate advantage gained by Mead through the nightly sweep of bank accounts" which was "not sufficient evidence that the two were functionally integrated." *Id.* at 35a. Moreover, this "approval of extraordinary purchases and considering the operations of Lexis/Nexis in its own strategic planning" was "not centralized management." *Id.* at 36a. No economies of scale were realized because "neither company enjoyed nor was offered a discount nor was required to purchase the products or services of the other" and the "testimony was that Lexis/Nexis often bought paper from other vendors." *Ibid.*

The trial court also noted that the fact that the two different businesses had filed, under protest, a tax return as a unitary business at the directive of the Illinois Department of Revenue did not change that fact. *Id.* at 38a. The court relied on a stipulated record from the parties, as well as on extensive expert testimony.[5]

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[5] Two tax expert witnesses and one expert witness in economics testified and submitted reports detailing their findings. Pet. App. 71a (tax expert Richard D. Pomp testified that no operational relationship existed between Mead and Lexis/Nexis); Pet. App. 57a (tax expert Walter Hellerstein testified that the relationship between the two businesses "involved no meaningful functional integration, centralized management, or economics of scale" and that neither asset "served an operational function in each other's business"); Pet.

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Because the two businesses are not a unitary business, the mere fact that The Mead Corporation operated in Illinois did not give Illinois the right to tax Mead on its gain from its sale of Lexis/Nexis. Rather, Illinois was entitled to tax Mead on that gain only if the capital transaction served an "operational function" to Mead, in which case the gain would be apportionable among the States in which that business was conducted, including Illinois which could then tax Mead on its apportioned share.

The Mead Corporation contended that neither the investment in Lexis/Nexis nor its sale served an operational function in Mead's business of selling paper and office supplies, but instead served only as a passive investment. The trial court, however, rejected that argument. The trial court ruled that "Mead's investment in Lexis/Nexis" served "an operational purpose," based on the lone observation that "Lexis/Nexis represented a significant business segment of Mead" that Mead had the power to "expand or contract" the Lexis/Nexis business. Pet. App. 38a-39a.

App. 93a (economics expert Ferdinand P. Schoettle concluding that there was "virtually zero" operational integration between Mead and Lexis/Nexis and that Lexis/Nexis was a " 'stand alone' company"). These expert reports are reprinted in the appendix to the petition. Pet. App. 48a-58a (Hellerstein report); Pet. App. 59a-77a (Pomp report); Pet. App. 78a-103a (Schoettle report).

2. The Appellate Court of Illinois, First Judicial District, affirmed. Pet. App. 1a-24a.

The court recognized that the facts "are essentially undisputed." Pet. App. 2a. The court ruled that Mead's gain on its sale of Lexis/Nexis was apportionable by Illinois for its taxation of a share of the gain because Mead's investment in Lexis/Nexis served an operational function for Mead.[6] Pet. App. 11a. The court did not, however, explain how Lexis/Nexis or its sale contributed to the operational function of Mead's unitary paper and office supplies business. Instead, the court cited Mead's 100 percent ownership interest in Lexis/Nexis, its contributions to Lexis/Nexis's capital, and its description of the Lexis/Nexis business in its annual reports and Forms 10-K. Pet. App. 12a-13a. The court rejected Mead's constitutional challenge to imposition of the tax. *Id.* at 17a-18a.

The court granted Illinois' motion that the decision be published as a precedential decision. Pet. App. 42a-47a.

3. The Supreme Court of Illinois denied review. Pet. App. 41a.

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[6] The Appellate Court of Illinois did "not address the Department's claim of error as to the [Circuit Court's] 'lack of unitary business' finding." Pet. App. 11a.

SUMMARY OF ARGUMENT

I.

A. The Commerce and Due Process Clauses of the United States Constitution prohibit a State from taxing activity that occurs, or value that is earned, outside its borders. In the case of a corporation that conducts its business in multiple States, a State in which the corporation is not domiciled must measure the amount of the multi-state corporation's income that it can tax based on the contribution that the corporation's activity in that State makes to the multi-state business.

States in which multi-state corporations operate have used various methods to measure what portion of a multi-state corporation's income they can tax. A straightforward approach is geographical or transaction accounting, which relies on where the activity occurs, but that may not fully reflect the in-State contribution to the overall business by ignoring unquantifiable value that is earned by the business but which is not readily associated with a particular State or States. Therefore, States often tax an apportioned share of a multi-state corporation's total income in an attempt to capture value that the geographical or transaction approach would miss.

The Court has approved of such state tax apportionment in two circumstances. First, the Court has upheld as constitutional a State's taxation of a multi-state corporation for a portion of its total income derived from its "unitary business" when the

State apportions to the State a share of that total income that reflects the in-State contributions to that income. Second, the Court has sustained a State's tax of a multi-state corporation for the gain associated with a nonunitary asset or investment where that asset or investment nonetheless served an integral "operational function" for the corporation's unitary business, and was not a mere return on its invested capital.

B. The Mead Corporation's gain on the sale of Lexis/Nexis is the paradigmatic example of a gain that cannot be constitutionally taxed by a State based merely on the fact that Mead operated in that State. Because Lexis/Nexis's computerized electronic data retrieval business was not unitary with Mead's business (*i.e.*, manufacturing and selling paper and office supplies), the only constitutional basis on which Illinois could tax Mead's gain on the sale of Lexis/Nexis would be if Lexis/Nexis served an operational function in Mead's unitary business, but it did not.

A nonunitary asset of a business serves an operational function in that business only if the asset provides ongoing (as opposed to occasional) support to critical aspects of the business, which was not so here. Mead's ownership of Lexis/Nexis was a long-term, passive investment that was, for 26 years, maintained separate and distinct from the business of manufacturing paper and office supplies. Mead did not use Lexis/Nexis as a source of working capital or

to support its paper and office supplies business in any other way.

The fact that Mead monitored Lexis/Nexis's performance, as any prudent investor would do, does not transform the investment into an operational asset that sustained Mead's business. This Court recognized in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), that in order to "convert an otherwise passive investment into an integral operational one," *id.* at 788, it is not enough that the investment was "'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business,'" *id.* at 789 (quoting *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 326 (1982)). Otherwise, all of a corporation's investments would always satisfy the operational function test because they always in some way relate or contribute to the corporation's business. Accordingly, the court below wholly ignored the requirement that the investment be used or designed to sustain and support Mead's business when the court relied, instead, on the fact that Mead derived economic benefit from its ownership in and sale of Lexis/Nexis.

The court's reliance upon Mead's ownership of Lexis/Nexis, its minor oversight over and capital investment in the asset, and its description of the asset's business in Mead's annual reports and Forms 10-K bear no relation to the operational function test. That test looks for a significant nexus between the investment and the taxable *activities* in the State,

and not a mere connection to the taxable *business*. Indeed, if these factors were relevant at all (and this Court's precedents say otherwise), they could inform only whether Lexis/Nexis was part of Mead's unitary business, an argument rejected below.

II.

The Illinois appellate court's decision eviscerates the federal constitutional limits on state taxation. Under the decision of the court below, all gain earned by a multi-state corporation from any wholly-owned subsidiary or division—even where that subsidiary or division lacks any relationship with the parent's regular business which is conducted in multiple States—is taxable by all of those States on an apportioned basis. This is so because each of the factors that the state court viewed as dispositive in this case is present in every relationship with a corporate parent and its business units, even if there is no unitary relationship between them.

A. Illinois's argument that there is a flow of value between Mead and Lexis/Nexis that justifies its taxation of Mead on the gain from the sale of Lexis/Nexis is based upon a misreading of this Court's precedents. A "flow of value" between a taxpayer parent and its subsidiary or division is relevant to whether there is a unitary relationship and not to whether the asset or its disposition served an operational function, and it is not satisfied by a mere occasional flow of funds or other benefits.

Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 166 (1983). Otherwise, a State's taxation of a parent on an apportioned share of all of the income of all of the parents' wholly-owned subsidiaries or divisions would nearly always be constitutionally permissible.

Indeed, Illinois's position that it need *not* demonstrate that the Lexis/Nexis electronic, online research business was used *at all* to benefit Mead's paper and office supplies business is contrary to this Court's requirement that there be a connection between the taxing State and the taxed conduct. More than a century of this Court's precedents have required a relationship between the income being taxed and the business's activities in the taxing State.

B. The Illinois appellate court's holding that a corporation's ownership of a business is the critical factor to determine whether that corporation's gain from the sale of the business is apportionable among the many States in which the corporation operates would lead to severe misattribution of income. The rule would upset well-established apportionment principles upon which both corporations and state taxing authorities rely. It would strip Illinois's sister States of legitimate claims to a portion of their tax base.

III.

The Illinois appellate court's decision threatens to subject multi-state corporations to unconstitutional multiple taxation. The Constitution precludes a State from overreaching into the portion of the tax base that belongs to a sister State, because doing so creates the threat of multiple taxation and thus burdens interstate commerce. By imposing a tax on The Mead Corporation's gain of its investment in Lexis/Nexis, Illinois overreached into a tax base that belongs of right to Ohio. Because Ohio has the constitutional claim to tax the entirety of Mead's gain at issue here, Illinois's taxation of an apportioned share creates a substantial threat of unconstitutional duplicative taxation.

ARGUMENT

I. THE CONSTITUTION PROHIBITS ILLINOIS FROM TAXING THE MEAD CORPORATION ON ITS SALE OF LEXIS/NEXIS BECAUSE THAT GAIN OCCURRED OUTSIDE ILLINOIS AND THAT ASSET WAS UNRELATED TO MEAD'S BUSINESS OF PAPER AND OFFICE SUPPLIES

The Commerce and Due Process Clauses prohibit a State from taxing a gain earned outside its borders. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777 (1992).

Illinois taxed The Mead Corporation, a nondomiciliary company, on its gain on the sale of its investment in Lexis/Nexis. But the sale was a capital

transaction that occurred outside the borders of Illinois, and Mead's ownership of Lexis/Nexis—the electronic, online research business—bore no relation to and was not integrated with Mead's paper and office supplies business that operated in Illinois and other States.

Accordingly, Illinois lacked the requisite constitutional nexus to tax an apportioned share of that gain. Illinois's tax on The Mead Corporation for its gain from its sale of its investment in an electronic, online research business that was distinct from Mead's paper and office supplies business crossed the line to unconstitutional taxation.

A. The Commerce And Due Process Clauses Require That A State Possess A Concrete Connection To Activities That It Taxes

1. A State can tax only the in-State value of a multi-state business

States have long struggled over how to maximize their taxes on multi-state corporations in a manner that comports with the Commerce and Due Process Clauses.

The Commerce Clause prohibits States from imposing extraterritorial taxes because of the "drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation" by the multiple States in which the businesses operate. *Allied-Signal*, 504 U.S. at 777-778. The Due Process

Clause requires that a State possess a "minimal connection" to a multi-state activity of a nondomiciliary business that it taxes and a rational relationship between the portion of such activity on which the State imposes the tax (*i.e.*, the amount apportioned to the State), and the interstate value of the multi-state business's activity. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978). This means "that, in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection to the actor the State seeks to tax." *Allied-Signal*, 504 U.S. at 778 (citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 306-308 (1992)).

Because of these constitutional limitations, States must measure, and can tax *only*, the in-State contribution to a multi-state corporation's income. This Court has recognized that such measurement of in-State contribution to the "value" of a "more-or-less integrated business enterprise operating in more than one State" can be "an elusive goal, both in theory and in practice." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983).

States have taken different approaches to measuring the value added to a multi-state business within their borders in order to maximize their tax revenue. Geographical or transactional accounting provides one method for States to identify locally taxable income. Such accounting isolates portions of income received within the borders of various States by a multi-state corporation. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 438

(1980). This accounting and taxation may, however, undercalculate the tax base by "ignor[ing] or captur[ing] inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Container Corp.*, 463 U.S. at 164-165; *see also Mobil Oil*, 445 U.S. at 437 (noting that such method "may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale").[7]

Efforts by the States to capture the value that may be missed by geographic and transactional accounting date back to the early era of railroads and telegraphs when the States first "encountered the difficulty that what makes such a business valuable is the enterprise as a whole, rather than the track or wires that happen to be located within a State's borders." *Allied-Signal*, 504 U.S. at 778. This Court held then that the Constitution thus permits "a State [to] base its tax assessments upon 'the proportionate

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[7] That geographical and transactional accounting may sometimes be underinclusive does not render its application as unconstitutional because a State may adopt a method of taxation that does not realize all constitutionally permissible taxes. *See Container Corp.*, 463 U.S. at 167-168 (noting that "a State might decide to respect formal corporate lines and treat the ownership of a corporate subsidiary as *per se* a passive investment" even though that "is not constitutionally required"). The fact that one State may decide to tax *less* than what is constitutionally permissible does not provide other States with the latitude to tax more than their own in-State contributions to the entire enterprise.

part of the value resulting from the combination of the means by which the business was carried on, a value existing to an appreciable extent throughout the entire domain of operation.'" *Id.* at 778-779 (quoting *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 220-221 (1897)). As such, where a multi-state corporation's income is derived from a "series of transactions" (from manufacturing to sale) that cross the territorial borders of multiple jurisdictions, a State can tax an apportioned share of the multi-state company's total income that reflects the value that was fairly attributable to "the processes," rather than just the receipts, "conducted within its borders." *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-121 (1920).

Thus, States now often tax an apportioned share of the total income of a multi-state corporation. This Court has approved such apportionment as a general matter, but also has held that it cannot be used to expand a State's putative tax base beyond constitutionally permissible bounds. *See, e.g.*, *Allied-Signal*, 504 U.S. 768; *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F. W. Woolworth Co. v. Taxation & Revenue Dep't of the State of New Mexico*, 458 U.S. 354 (1982). For example, in *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931), the Court ruled that a State tax apportionment method based entirely upon ownership of tangible property resulted in an attribution to North Carolina of income that was out of proportion to the taxpayer's business in the State. The Court held that the method, "albeit fair on its

face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction." *Id.* at 134.

The limitations on state taxation of multi-state corporations imposed by the Commerce and Due Process Clauses thus prohibit a State from sweeping into its coffers value that is properly taxed only by its sister States. State laws that tax an apportioned share of a multi-state corporation's economic activity are limited by the Constitution to taxing the in-State contributions to the taxed business. *Ibid.*

2. A State may tax an apportioned share of an activity of a multi-state corporation only if that activity is part of the corporation's unitary business that operates in the State or is used to operationally support that unitary business

Illinois agrees, as it must, that the apportionment method of state taxation of a multi-state corporation is permissible only in two circumstances—"if the multistate operation is run as a single unitary business or if the asset or transaction a State seeks to tax served an operational function" for the corporation's unitary business operating in the State. Br. in Opp. at 7. Indeed, this Court has repeatedly held that "the *linchpin* of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil*, 445 U.S. at 439 (emphasis added). The operational function test, by contrast, constitutes a narrow *exception* that permits a State to tax

an apportioned share of income or gain from an asset or investment that is *not* part of the unitary business if, for example, the asset "forms part of the working capital of the corporation's unitary business." *Allied-Signal*, 504 U.S. at 787.

Both circumstances where a State may tax an apportioned share of a multi-state business's income or other economic gain are based upon the same rationale. The unitary business principle and the operational function test seek to capture the "subtle and largely unquantifiable" in-State contributions to the overall value of a multi-state business. *Container Corp.*, 463 U.S. at 164-165; *see also Allied-Signal*, 504 U.S. at 783. Apportionment is permissible under the unitary business principle only where several businesses, as part of common ownership or as different parts of the same business, are so functionally dependent upon each other that the value of the whole is greater than the sum of its parts. Apportionment of the value of the whole then provides a more accurate measure of the in-State contribution to that business that an individual State may tax than just the taxation of a particular segment of the business in that State.

This Court has explained that a State calculates the in-State contribution to a business "by first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part." *Container Corp.*, 463 U.S. at 165. Then the State "apportion[s] the total income of that 'unitary business' between the taxing

jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." *Ibid.*; *see also Mobil Oil*, 445 U.S. at 437 (a State can tax an apportioned share of the income of a multi-state corporation "so long as the intrastate and extrastate activities formed part of a single unitary business").

And where a multi-state corporation receives income or gain from an asset or investment that is separate from the corporation's unitary business conducted in the taxing State, the State may tax an apportioned share of that income or gain only in the limited circumstances allowed by the operational function test. *Allied-Signal*, 504 U.S. at 789. That test allows the State to tax the multi-state corporation only where the asset or investment provided on-going "integral operational" support to the unitary business operating in the taxing State. *Id.* at 788; *ASARCO*, 458 U.S. at 326. That test does not allow a State to tax a multi-state corporation if the income from the asset or investment was just "a return on its invested capital." *ASARCO*, 458 U.S. at 326.

States do *not* have unlimited latitude under the Commerce and Due Process Clauses to tax an apportioned share of the entirety of a multi-state corporation's income or gain merely because the corporation conducts business in the State. The unitary business principle and the operational function test impose a "necessary limit on the States'

authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." *Allied-Signal*, 504 U.S. at 780; *see also Container Corp.*, 463 U.S. at 166 (requiring that "the out-of-State activities of the purported 'unitary business' be related in some concrete way to the in-State activities").

B. The Mead Corporation's Investment In And Sale Of The Lexis/Nexis Online Research Business Is The Paradigmatic Example Of A Non-Apportionable Gain

The trial court correctly ruled that The Mead Corporation and Lexis/Nexis were not a unitary business. Pet. App. 38a. None of the indicia of a unitary business were present. Illinois entered into a stipulation that established that Mead's business to manufacture and sell paper and office supplies was distinct and separate from the Lexis/Nexis electronic online research business in virtually every way. J.A. 9-16. The two were in completely separate and unrelated lines of business and operated under different brands. J.A. 10. They had separate departments for virtually every corporate function, including among others, human resources, accounting, legal, and marketing. J.A. 10-11. There was no integration between the two businesses, and Lexis/Nexis was run as a completely autonomous business that was not subject to operational oversight by The Mead Corporation. J.A. 13. The two lines of business segregated and kept separate all accounts,

shared no facilities, shared no employees, and made independent employee decisions. J.A. 12-13.

Thus, under this Court's well-settled principle and as the trial court concluded, apportionment to Illinois of a portion of Mead's gain on its Lexis/Nexis sale was not permitted under the "unitary business" principle because the out-of-state event that Illinois sought to tax did not give rise to income that "'result[ed] from functional integration, centralization of management, [or] economies of scale'" of the unitary business conducted in Illinois. *ASARCO*, 458 U.S. at 317 (quoting *Mobil Oil*, 445 U.S. at 438).

The trial court erred, however, when it nonetheless upheld the apportionment to Illinois of a portion of Mead's gain on its Lexis/Nexis sale under the "operational function" test. This Court permits a State to tax an apportioned share of the gain or income from a nonunitary asset or investment under that test only in circumstances where that asset provides a continuing, significant contribution to *support* the unitary business conducted in the State in some substantial, operational capacity. That was not the case here.

1. The Mead Corporation's investment and sale of Lexis/Nexis served no operational function for Mead's paper and office supplies business and thus cannot be taxed by Illinois

Illinois acknowledges (Br. in Opp. 8) that this Court has articulated few circumstances in which income or gain from a nonunitary asset can nonetheless serve an operational function to a unitary business operating within the taxing State, and thus be taxed on an apportioned basis. Those circumstances include where the asset is used to regularly fund the working capital of the unitary business that operates within the taxing State, or where the asset, itself, is designed to support the unitary business with the requisite nexus to the taxing State, such as by providing an on-going stable supply of key resources. *Ibid.* (citing *Allied-Signal*, 504 U.S. at 778). The Court has provided the example of "the interest earned on short-term deposits in a bank located in another State" as an activity that serves an operational function "if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank." *Allied-Signal*, 504 U.S. at 787-788. Likewise, "loans and loan guarantees" that support "operations" in the same lines of work as the unitary business, *Container Corp.*, 463 U.S. at 178, 180 n.19, and gains from hedging against market risk in the commodity futures markets from supply shortages for the

unitary business, *Corn Products Refining Co. v. Commissioner of Internal Revenue*, 350 U.S. 46 (1955), can also satisfy the operational function test.[8] *See also ASARCO*, 458 U.S. at 324 n.21 (noting that nonunitary "stock investments" could have served an operational function had they "been accumulated for the future operation of [ASARCO's] own primary business").

In those circumstances, the operational function test justifies the State taxing the corporation for the income or value from that non-unitary asset or investment when that income or value is used in a regular, on-going operational capacity by the parent's unitary business within the taxing State (such as by funding key segments or functions or by providing a regular supply of certain raw materials), because that income then is *related to* activities carried on in the taxing State. *See Allied-Signal*, 504 U.S. at 787; *see also* Walter Hellerstein, *State Taxation of Corporate Income from Intangibles:* Allied-Signal *and Beyond*, 48 TAX L. REV. 739, 791 (1993).

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[8] In *Container Corp.*, this Court cited *Corn Products Refining* as an example, "in another context," of how "capital transactions can serve either an investment function or an operational function." *Container Corp.*, 463 U.S. at 180 n.19. Although *Container Corp.*, itself, discusses the operational function test, the facts of that case relate to the unitary business, which is the ground on which the case was decided. *See id.* at 178 (noting that the parent and subsidiary were "engage[d] in the same line of work" so that the subsidiary supported the parents "through economies of scale or through operational integration or sharing of expertise").

There is no reason to believe that the sale of a nonunitary asset of the sort at issue here—*i.e.*, where Mead had the ability to control the nonunitary Lexis/Nexis business but did not—could *ever* satisfy the operational function test. *Allied-Signal*, *Woolworth*, and *ASARCO* suggest as much. The Court in *Allied-Signal* explained that to satisfy the operational function test the "capital transaction," itself, must "serve an operational rather than an investment function." *Allied-Signal*, 504 U.S. at 787. And just as the *sale* of Lexis/Nexis—*i.e.*, the capital transaction Illinois seeks to tax—did not serve any operational function to Mead, neither did the sale of stock in *Allied-Signal*, nor the sale of subsidiaries in *Woolworth*, nor the dividends, interest income, or capital gains in *ASARCO*. Indeed, this Court has explained that the capital transactions in *ASARCO* could have been apportionable to the nondomiciliary taxing State *if* the "stock investments there constituted interim use of idle funds accumulated for the future operation of the taxpayer's business." *Allied-Signal*, 504 U.S. at 787 (internal quotations, brackets, and omissions omitted).

Moreover, assuming it were enough that the nonunitary asset served an operational function *even if* its sale did not (something this Court has never before endorsed), Illinois still could not satisfy that standard to justify taxing the sale. In the instant case, the courts below did not make, nor could the record support, the constitutionally required finding that Mead's nonunitary investment in Lexis/Nexis

served an operational function to Mead's business to manufacture and sell paper and office supplies which operated, *inter alia*, in Illinois. *Allied-Signal*, 504 U.S. at 778 ("in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax").

Mead never used its investment in Lexis/Nexis (or any profits derived from it) as a de-facto account from which to withdraw profits in order to fund the working capital of Mead's unitary business. Ill. C.A. Rec. Vol. 9 at 214. Nor did Mead's investment in Lexis/Nexis otherwise support the unitary business in any other capacity. J.A. 10-13, 164-168, 172-173, 177-179. For example, not only did Lexis/Nexis *not* provide critical on-going financial support to Mead's unitary business, but it also did *not* provide Mead any guarantee of key supplies to that business which manufactures and sells paper and office supplies.

Rather, Mead's ownership of Lexis/Nexis was a long-term passive investment (it had been acquired as part of an acquisition of an ink-jet printing technology, J.A. 152-153), that was maintained separate and distinct from Mead's primary business for 26 years. *See Allied-Signal*, 504 U.S. at 790 (noting that a two-year investment was sufficiently long-term so as to not serve an operational function). Indeed, to the extent there was any contribution between the two businesses that was relied upon by the court below to justify apportionment, the direction in which that contribution flowed—in the

form of occasional capital contributions—went *from* Mead, as an investor, *to* Lexis/Nexis.

2. Mead's action as a prudent investor did not transform its non-operational, passive investment into one that satisfied the operational function test

Illinois ignores the limited scope of the operational function test and argues that its taxing authority extends to a nondomiciliary corporation's out-of-state sale of a nondomiciliary business based solely on the fact that the nondomiciliary corporation, The Mead Corporation, did what any prudent investor may do, *i.e.*, ensure that its investment in Lexis/Nexis was profitable and beneficial to Mead and its shareholders. *See, e.g.*, Pet. App. 13a ("Mead developed Lexis/Nexis by contributing capital support until it became profitable.").

Mead unquestionably kept track of how its Lexis/Nexis investment performed. Basic corporate fiduciary responsibility required as much, for even the most passive investments held by a corporation. *See, e.g.*, 1-1 William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors* § 1.02 (1969) (stating that reviewing the corporation's investments is among the directors' duties); American Bar Ass'n, *Corporate Director's Guidebook*, 49 BUS. LAW. 1247, 1249 (1994) (listing a director's activities to include "approving fundamental operating, financial, and other corporate plans, strategies and

objectives"). Accordingly, Mead's Board of Directors necessarily had authority with respect to some of the highest level of decisionmaking in Lexis/Nexis, J.A. 15 (approving large capital expenditures), or else they would have abdicated the responsibility that they had to Mead's shareholders, *see Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006) (a duty of care is imposed on the Board to its shareholders).

But Mead's limited actions as a prudent investor do not convert its nonunitary investment into one that is subject to apportionment for state taxation wherever Mead's paper and office supplies business was conducted. This Court in *Allied-Signal* and *ASARCO* recognized as much. In addressing whether a "long-term corporate strategy" could "convert an otherwise passive investment into an integral operational one," the *Allied-Signal* Court held that it is not enough that the investment was " 'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business.' " *Allied-Signal*, 504 U.S. at 788 (quoting *ASARCO*, 458 U.S. at 326). "The business of a corporation requires that it earn money to continue operations and to provide a return on investment. Consequently *all* of its operations, including any investment made, in some sense can be said to be for purposes related to or contributing to the [corporation's] business." *Id.* at 789 (quoting *ASARCO*, 458 U.S. at 326) (brackets in original, internal quotations omitted). To allow States to apportion income for state taxation based on no more

than such a showing would make the constitutional limitation "no limitation at all." *Ibid.*[9]

3. The Illinois appellate court relied upon factors that are inapplicable to the operational function determination

The Illinois appellate court reached its clearly erroneous conclusion because it conflated the factors relevant to the unitary business inquiry with the operational functional test. Presumably, in circumstances unquestionably not present here, more substantial evidence of that sort might demonstrate a unitary business relationship. But in the instant case, there was no such showing, and the trial court was correct when it found no unitary business relationship. Accordingly, the fact that Mead received

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[9] Indeed, it is common for a parent corporation to occasionally oversee a subsidiary or division "with respect to capital structure, major debt and dividends," *F. W. Woolworth Co. v. Taxation & Revenue Dep't of the State of New Mexico*, 458 U.S. 354, 369 (1982), but that fact does not alter the operational function analysis. Rather, that demonstrates only that Mead had "the *potential* to operate a company as part of a unitary business," *id.* at 363, which says nothing about whether the investment in Lexis/Nexis served an operational function. *See also* pages 38-40 *infra*.

Moreover, although not relied upon by the courts below, Mead's use of the gain from the sale of Lexis/Nexis is not relevant to the operational function test. *Allied-Signal*, 504 U.S. at 790. Even if it were, however, the gain itself served no operational function, because it was used to repurchase stock, retire debt, and pay taxes. J.A. 14-15.

tax benefits from and directed money to its investment in Lexis/Nexis, approved some of its major debt and capital expenditures, altered the corporate form of Lexis/Nexis on occasion, and included Lexis/Nexis in its annual reports and Forms 10-K, *see* Pet. App. 12a-14a, showed no more than a *connection* between a parent and its business unit, as opposed to the functional integration, centralization of management, and economies of scale that the unitary business principle requires and that Illinois could not satisfy. *ASARCO*, 458 U.S. at 317; *Mobil Oil*, 445 U.S. at 438. Indeed, these factors demonstrated only the obvious—that Mead owned Lexis/Nexis. *See Wallace v. Hines*, 253 U.S. 66, 69-70 (1920); *Woolworth*, 458 U.S. at 363.

The appellate court's use of these factors thus created a diluted unitary business relationship test as a proxy for demonstrating an operational function. Whether considered individually, or collectively, these factors relied upon by the Illinois court fail to show that Lexis/Nexis, a cutting-edge information technology business, served any operational function whatsoever for Mead's traditional paper and office supplies business. *See Allied-Signal*, 504 U.S. at 788-789.[10]

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[10] Indeed, in its motion to publish the state court decision as precedential, Illinois recognized the novel nature of the ruling below. Illinois argued that the decision provided "crucial guidance" by setting forth specific factors, "such as on-going capital support, approval of major capital expenditures, manipulation of business organizations, and retaining benefits

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First, the fact that Lexis/Nexis was 100 percent owned by Mead was irrelevant to whether the Lexis/Nexis investment served an operational function to Mead's paper and office supplies business because the wholly-owned nature of the relationship says nothing about the use of the asset or income from it as it relates to in-State activities. This Court in *F. W. Woolworth Co. v. Taxation & Revenue Department of the State of New Mexico*, 458 U.S. 354, 356-357 (1982), recognized that 100 percent ownership is not a relevant consideration, because there Woolworth and its four subsidiaries were not part of a unitary business even though three of those subsidiaries were wholly owned by Woolworth.

Second, Mead's occasional participation in the direction of its Lexis/Nexis investment, which included changing Lexis/Nexis from a division to a corporate subsidiary and back to a division again, Pet. App. 13a,[11] showed at most only limited control

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and control of excess cash" as relevant to when a "business unit qualifies as an operational asset." Pet. App. 45a. The State, in particular, found significant the fact that the appellate court "approved of specific evidence on which the [State] and courts can rely in making this determination—such as annual reports and federal 10-K statements." *Ibid.*

[11] This Court has explained that it is of no moment that Lexis/Nexis was a division rather than a subsidiary, or vice versa. "[T]he form of business organization may have nothing to do with the underlying unity or diversity of business enterprise." *See Mobil Oil*, 445 U.S. at 440; *see also Edison California Stores v. McColgan*, 183 P.2d 16, 21 (Cal. 1947) (explaining that "no difference in principle is discernable" when discussing the

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and does not demonstrate that that control led to Mead's use of that nonunitary Lexis/Nexis asset in a manner that served an operational function that was critical or important to Mead's business. Indeed, even under the unitary business analysis, such "occasional oversight," or even the *power* to operate a subsidiary or division as part of a unitary business, is insufficient to justify the apportionment of income by a non-domiciliary State. *Woolworth*, 458 U.S. at 369 ("Except for the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management * * *."); *see also id.* at 362 ("the *potential* to operate a company as part of a unitary business is not dispositive when, looking at the underlying economic realities of a unitary business, the dividend income from the subsidiaries *in fact* is [derived] from unrelated business activity which constitutes a discrete business enterprise") (emphasis in original) (citations and internal quotations omitted).

It would be irrational to afford such occasional oversight greater significance under the operational function test. Indeed, the Court's ruling in *Woolworth* makes this clear because, of course, when a business is 100 percent owned by another, the owner will have

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difference in corporate form between a subsidiary and a division).

the right to change the form of the business, and the right to any tax advantages resulting from that change in form of the business. But that ownership does not demonstrate an operational function, and the factors that necessarily follow therefrom therefore do not do so either.

Third, Mead's capital investment in Lexis/Nexis as well as the fact that Mead ensured that Lexis/Nexis's excess cash was invested back *into* Lexis/Nexis was not proof that Lexis/Nexis—the electronic, online research business—served an operational function for Mead—the paper and office supplies business. As discussed above, *see* pages 34-35 *supra*, corporations are required to care for their investments, and that fact alone does not give a State the authority to tax an apportioned share of the sale of any wholly-owned subsidiary or division by any corporation that has a business operating in the State. Indeed, under the ruling below, all such gain, "irrespective of whether it is generated by a 'discrete business enterprise,'—would become part of a unitary business if the test were whether the corporation commingled dividends from other corporations, whether subsidiaries or not." *Woolworth*, 458 U.S. at 364 n.11 (citation omitted).

Fourth, Mead's description of the Lexis/Nexis business in its annual reports and Forms 10-K is erroneously viewed by the State (and the court below) as nearly dispositive of Illinois's right to tax an apportioned share of Mead's gain on the Lexis/Nexis sale. Pet. App. 36a-37a. But this Court "focuses on the

objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State" and not on the manner in which the company listed its "profits entry on a financial statement." *Allied-Signal*, 504 U.S. at 785; *see also Woolworth*, 458 U.S. at 369 n.22 (consolidated accounting and consolidated statements do not lead to a conclusion that there existed a unitary relationship).

In sum, Illinois cannot overcome the absence of any evidence that Mead's ownership of Lexis/Nexis provided an on-going significant contribution to sustain and support Mead in a critical operational capacity. And the Illinois appellate court's reliance on the fact that Mead owned and benefited from Lexis/Nexis ignores this Court's repeated "demand" that States demonstrate "more" because a business "derives some economic benefit—as it virtually always will—from its ownership of stock in another corporation." *Woolworth*, 458 U.S. at 364; *see also Wallace*, 253 U.S. at 69-70.

II. ILLINOIS'S VIEWS WOULD EVISCERATE THE CONSTITUTIONAL LIMITS ON STATE TAXATION OF MULTI-STATE CORPORATIONS' EXTRATERRITORIAL INCOME AND GAINS

The Illinois appellate court's decision constitutes a radical departure as to how a corporation's income and gains from wholly-owned subsidiaries or divisions can be constitutionally taxed. By focusing on the fact that

Lexis/Nexis was owned by The Mead Corporation, without examining Lexis/Nexis's connection to Mead's paper and office supplies business, the decision below effectively requires that all income or gains from a wholly-owned subsidiary or division be taxable at the parent on an apportioned basis. This would be the case *even if* (as here) the division itself had no relationship to the parent company's unitary business being conducted within the taxing State.

Indeed, the justifications of the court below for permitting Illinois to tax a nondomiciliary parent on a share of the gain from a nonunitary investment are present whenever a parent corporation acquires a wholly-owned business or subsidiary. *See Woolworth*, 458 U.S. at 363. But the mere existence of such a relationship cannot make all income or gain earned by that parent from that separate business taxable on an apportionable basis. Nor can the other criteria relied upon by the court below be dispositive as to whether a State can tax an apportioned share of such a subsidiary or division. There is always the potential (and occasional) control over the activities of a subsidiary or division, some investment in and some benefit received from the subsidiary or division, and some characterization of the subsidiary's or division's business as it relates to the parent company's business as a whole. *See* pages 34-35 *supra*. But those factors alone do not justify state taxation of the parent corporation. *ASARCO*, 458 U.S. at 326 ("The business of a corporation requires that it earn money

to continue operations and to provide a return on its invested capital.").

A. Illinois Proposes Rules In Which There Are Virtually No Limits On A State's Power To Tax Multi-State Corporations

Focusing on factors that pertain to the existence of a unitary business relationship—the purported flow of some value between The Mead Corporation and Lexis/Nexis and the minimal corporate connections that *must* exist between the two—Illinois proposes a standard that would make taxation on an apportioned share of all of a parent's subsidiaries or divisions constitutionally permissible in virtually all circumstances.

1. Illinois argues that "the focus of the apportionment inquiry remains the flow of value between the business units and management's role in the business unit's affairs," Br. in Opp. at 9, and insists that Mead's investment in Lexis/Nexis satisfies that standard.

But that argument pertains to whether there is a unitary business relationship and, in any event, reads this Court's decisions too broadly. Illinois's construction of these principles would allow a State to tax a nondomiciliary corporation on virtually all income or other gain from its subsidiaries or divisions regardless of any connection to the corporation's business operating in the taxing State. As discussed above (pages 38-40 *supra*), focusing on the "managerial role" played in the business unit's affairs

says nothing about whether an asset or its sale served an operational function to the taxable in-State business. It goes to whether the asset and in-State business are part of a unitary business relationship. *See, e.g.*, *Woolworth*, 458 U.S. at 369-370 (analyzing the taxpayer's management role of its subsidiaries in determining whether the subsidiaries were part of the taxpayer's unitary business); *see also Container Corp.*, 463 U.S. at 180 n.19 ("We made clear in *F. W. Woolworth Co.* that a unitary business finding could not be based merely on the type of occasional oversight * * * that any parent gives to an investment subsidiary.") (internal quotations and citations omitted).

Moreover, this Court has cautioned that the mere flow of some benefits between two business units does not permit virtually *all* investments to be subject to taxation on an apportioned basis under either the unitary business principle or the operational function test, and Illinois and the state court were wrong to suggest otherwise. Rather, a contribution or transfer of value is a necessary but not always sufficient prerequisite for a State to tax an apportioned share of a subsidiary or division. *Allied-Signal*, 504 U.S. at 783. What is required is "some sharing or exchange of value not capable of precise identification or measurement—*beyond the mere flow of funds* arising out of a passive investment or a distinct business operation—which renders formula apportionment a reasonable method of taxation." *Container Corp.*, 463 U.S. at 166 (emphasis added). The fact that the sale

of an asset "adds to the riches" or provides a "business advantage" to a multi-state corporation such as Mead is not enough, *Wallace*, 253 U.S. at 69-70; *Woolworth*, 458 U.S. at 363, because that would be true of any economic activity that produces value, which says nothing as to whether the asset had anything to do with the activities of Mead's unitary business in Illinois. *ASARCO*, 458 U.S. at 329-330.

2. Illinois maintains that a putative taxing State has no obligation to show that "the asset was utilized directly in the selling company's business." Br. in Opp. 8-9. But by eliminating that requirement, as Illinois suggests, a State need not show *any* nexus between the nonunitary asset and the taxable conduct within the taxing State. Rather, under Illinois's rule, *any* connection between the asset and the actor, *viz.*, the unitary business, is enough.

This Court has repeatedly held otherwise. *Allied-Signal*, 504 U.S. at 778 ("in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax") (citing *Quill*, 504 U.S. at 306-308). Illinois's proposed rule would overrule a century of precedent, including this Court's repeated resistance to efforts by States to tax economic activity occurring outside their borders. *See Wallace*, 253 U.S. at 69 ("The only reason for allowing a State to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic

system of wide extent, that gives them a value above what they would otherwise possess."); *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 222 (1897) ("We repeat that, while the unity which exists may not be a physical unity, it is something more than a mere unity of ownership. It is a unity of use, not simply for the convenience or pecuniary profit of the owner, but existing in the very necessities of the case,—resulting from the very nature of the business.").

Illinois's narrow focus on factors that demonstrate no more than the existence of a corporate connection between Mead and Lexis/Nexis as a basis for taxing an apportioned share of Mead's gain from the sale of Lexis/Nexis cannot be squared with this Court's precedents. Indeed, that position is almost indistinguishable from one repeatedly rejected by this Court: that "all income of a corporation doing any business in a State is, by virtue of common ownership, * * * apportionable." *Allied-Signal*, 504 U.S. at 784; *see also ASARCO*, 458 U.S. at 326 (rejecting Idaho's proposed rule that if intangible property is "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business" then it "should be considered a part of a unitary business"). This Court, however, has refused to "accept, consistent[] with recognized due process standards, a definition of 'unitary business' that would permit nondomiciliary States to apportion and tax dividends '[w]here the business activities of the dividend payor have nothing to do with the activities

of the recipient in the taxing States * * * .'" *ASARCO*, 458 U.S. at 327 (quoting *Mobil Oil*, 445 U.S. at 442).[12]

3. The shortcomings of the decision below are reflected in the fact that it conflicts with the decisions of other state courts. Indeed, state high courts that have considered these issues have not held that the mere existence of any economic contribution between a business and its nonunitary asset eliminates the requirement that the nonunitary asset be used operationally by the unitary business before the State can tax.

Thus, in *Hercules Inc. v. Commissioner of Revenue*, 575 N.W.2d 111, 117 (Minn. 1998), and *Hercules Inc. v. Comptroller of Treasury*, 716 A.2d 276, 282 (Md. 1998), the state courts of last resort in Minnesota and Maryland found that a nonunitary

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[12] By proposing a rule that would allow States to tax income or gain bearing no relationship to a business's activities *in* those States, Illinois is running against a wealth of academic scholarship. *See, e.g.*, Jerome Hellerstein, *Allocation and Apportionment of Dividends and the Delineation of the Unitary Business*, 14 TAX NOTES 155, 160 (1982) (if value is "derived" from a source outside the taxing State, and the value-generating asset is not "used in the unitary business conducted in the State, either as working capital or under the *Corn Products* analogy or otherwise," there is no justification for apportionment); Walter Hellerstein, *State Taxation of Corporate Income from Intangibles:* Allied-Signal *and Beyond*, 48 TAX L. REV. 739, 858 (1993); Note, *State Taxation of Foreign-Source Income*, 66 CORNELL L. REV. 805, 806 (1981); William D. Dexter, *Tax Apportionment of the Income of Unitary Business: An Examination of* Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 1981 BYU L. REV. 107, 119-20 (1981).

asset served no operational function, even though the two lines of business complemented and provided one another certain goods and services. Both courts held that their respective States could *not* tax an apportioned share of the gain from the sale of a nonunitary asset.

Likewise, the Alaska Supreme Court has held that a definition of "operational income" that applied whenever "investment decisions [are] obviously aimed at building [the corporation's] financial strength overall" "would swallow the distinction between operational and investment income." *Alaska Dep't of Revenue v. OSG Bulk Ships, Inc.*, 961 P.2d 399, 411, 414 (Alaska 1998). Even in decisions where the gain was apportionable, those state courts have confined the operational function test to the two circumstances previously articulated by this Court. *See also Pennzoil Co. v. Department of Revenue*, 33 P.3d 314, 318 (Or. 2001), *cert. denied*, 535 U.S. 927 (2002) (income related to an agreement to guarantee strategic petroleum resources); *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 345 (Cal.), *cert. denied*, 534 U.S. 1040 (2001) (income producing trust and pension plan was designed "to induce [unitary business's] current employees to stay and to attract new employees").

The fair, predictable and equitable application of the operational function test by these courts demonstrates both that this Court's test works in practice and that adoption of any new rule will disturb settled expectations upon which States and

corporations rely. *Allied-Signal*, 504 U.S. at 785 ("[I]f anything would be unworkable in practice, it would be for us now to abandon our settled jurisprudence defining the limits of state power to tax * * * . State legislatures have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary state * * * .").

B. Illinois's Tax Grossly Misattributes Taxes Among Domiciliary States and Non-Domiciliary States

If this Court were to adopt the Illinois court's holding that *ownership* is the linchpin of apportionability, not only would taxpayers' due process rights be affected, but severe income misattribution would occur. *See* Walter Hellerstein, *supra*, at 806. States would tax income that is in no way related to the taxpayer's activities in the State. Both corporations and States' administrators would face significant difficulties in applying apportionment formulae that have been in place for more than 50 years to income or other gain that has never been previously included in the apportionable tax base.

Misattribution of taxable income would strip States of legitimate claims to those portions of a multi-state corporation's tax base that would be arbitrarily assigned to other States. *See* Walter Hellerstein, *supra*, at 806-807. The fact that States stripped of legitimate tax revenue under an "ownership equals apportionment" rule would be able

to tax *other* income that they would not have been able to tax otherwise is inconsequential because this Court has held that "[w]e can accept the premise that apportionment is permitted only when precise geographic measurement is not feasible, for to allow apportionment where there is no practical or theoretical justification could provide the opportunity for a State to export tax burdens and import tax revenues." *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 374 (1991).

All of this would increase the need for judicial monitoring: "Without the unitary business principle to serve as a prophylactic device to confine the tax base to income arising from a related set of activities, there inevitably would [be] an increase in state tax apportionments that [bear] no reasonable relationship to the taxpayer's activities in the state." Walter Hellerstein, *supra*, at 807. Taxpayers, consequently, would seek relief from the courts in greater numbers, thereby reducing the efficiency of both tax collection and the judicial process.

III. The Decision Below Renders The Nation's Largest Corporations Vulnerable To Unconstitutional Duplicative Taxation

The threat of duplicative state taxation and the burden it imposes on interstate commerce is at the heart of this Court's Commerce Clause jurisprudence relating to state taxation of multi-state businesses.

Protection against duplicative taxation is embodied in the requirement that a State's tax on interstate activity be fairly apportioned. *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184-185 (1995). The prohibition against duplicative taxation "is threatened whenever one State's act of overreaching combines with the possibility that another State will claim its fair share of the value taxed: the portion of value by which one State exceeded its fair share would be taxed again by a State properly laying claim to it." *Id.* at 184-185. Accordingly, this Court "act[s] as a defense against state taxes which, whether by design or inadvertence, either give rise to serious concerns of double taxation, or attempt to capture tax revenues that, under the theory of the tax, belong of right to other jurisdictions." *Trinova*, 498 U.S. at 386.

The Constitution does not guarantee that a multi-state business will *never* be exposed to *any* overlapping taxation, because even where there has been no overreaching by a State, some risk of duplicative taxation is inherent when various States' inconsistent apportionment schemes apply. That occurs, however, only in circumstances where the taxing States each possess the constitutional authority to tax an apportioned share of the multi-state corporation's gains, not in the circumstances present in the instant case where the taxing State has no such authority at all.

As such, that circumstance arises only because this Court has made it clear that the Constitution does not mandate a single method of tax

apportionment to be used by each State, in part because selecting such an apportionment would involve complex policy questions and would be quintessentially legislative in nature. *See Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 279-280 (1978). Thus, provided that the "tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State," *Oklahoma Tax Comm'n*, 514 U.S. at 183 (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)), this Court has upheld tax-apportionment schemes despite a minor, "limited possibility of multiple taxation," *Goldberg v. Sweet*, 488 U.S. 252, 264 (1989). Nevertheless, when examining "whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State[,] * * * the threat of real multiple taxation * * * may indicate a State's impermissible overreaching." *Oklahoma Tax Comm'n*, 514 U.S. at 185.

This is not a case where there is a limited risk of duplicative taxation due solely to the applications of various state apportionment formulae. Rather, Illinois has taxed a gain that could be taxed in a manner consistent with the Constitution only by Ohio, because Lexis/Nexis was not a part of Mead's unitary business of manufacturing and sale of paper

and office supplies and served no operational function to that unitary business.[13]

Nor is the threat of duplicative taxation inchoate. States have relied on this Court's precedents and have established tax schemes allocating the entirety of intangible nonbusiness income to the domiciliary State. *Allied-Signal*, 504 U.S. at 785; *see also* pages 47-49 *supra* (demonstrating the divergent manner Illinois's sister States have addressed the operational function test). The Illinois court's decision, if permitted to stand, impermissibly permits a State with no nexus to a capital transaction to impose a duplicative tax on a portion of that transaction, despite the domiciliary State's right to tax the entirety of the same transaction. *See Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653, 662-663 (1948) (holding that a State's duplicative tax on the entirety of transaction was unconstitutional where two other States had the right to tax an apportioned share).

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[13] That Ohio's tax code may not actually tax the entire transaction is of no consequence. *See Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 228-229 (1980) ("[T]he constitutionality of [one State's] tax should not depend on the vagaries of [another State's] tax policy * * * ." (quoting *Mobil Oil*, 445 U.S. at 444 (second brackets in original))); *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653, 663 (1948) (stating that other States' lack of taxation on an interstate transaction would not justify a State's overreaching by taxing a greater portion of the transaction than it was entitled to). Illinois cannot extend its taxation beyond constitutional limits merely because one of its sister States may decide not to tax to the fullest extent permissible under the Constitution.

CONCLUSION

For the reasons set forth above, the judgment of the Appellate Court of Illinois should be reversed.

Respectfully submitted,

PAUL H. FRANKEL
Counsel of Record
CRAIG B. FIELDS
ROBERTA MOSELEY NERO
MORRISON & FOERSTER LLP
1290 Avenue of the Americas
New York, NY 10104
(212) 468-8000

BETH S. BRINKMANN
BRIAN R. MATSUI
NICOLE D. DEVERO
MORRISON & FOERSTER LLP
2000 Pennsylvania Avenue, N.W.
Washington, DC 20006
(202) 887-1544

Counsel for Petitioner

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